IFRS 3, IAS 16 and IAS 37: Contingent Consideration in an Asset Purchase

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IFRS 3 *Business Combinations* is clear that contingent consideration payable in a business combination should be recognized at fair value as part of the purchase price. However, IFRSs do not contain explicit guidance on the accounting for contingent consideration if the assets acquired do not constitute a business as defined in IFRS 3.

Fact Pattern:

Entity A acquires one or more assets that do not constitute a business. The assets are property, plant and equipment that will be accounted for in accordance with IAS 16 *Property, Plant and Equipment*. Entity A pays the seller cash consideration at the time of the purchase and agrees to pay additional amounts in one year's time based on a combination of factors, including whether Entity A is able to achieve production milestones with the assets and how profitable the operations are.

Issue: How should Entity A account for the contingent consideration payable?

View A – Contingent consideration payable should be measured at fair value and recorded as part of the cost of the purchase.

IAS 16 requires items to be initially recognized at cost. Cost is the cash equivalent price at the time of purchase, which can be argued to include the contractual arrangement to pay contingent consideration. As discussed in IFRS 3, contingent consideration in a business combination will often meet the definition of a financial instrument. Contingent consideration that is contractually agreed upon in an asset purchase is no different. It is appropriate to record contingent consideration payable at fair value at the time of the acquisition. There may be considerable judgment in determining the fair value, which would need to factor in the probability that contingent consideration will in fact be paid. However, this uncertainty does not negate the fact that a financial instrument exists and should be recorded as part of the cost of the asset(s) purchased.

View B – Contingent consideration payable should be measured and recorded at some other point (for example, when the conditions associated with the contingency are met).

In 2013, the IASB considered an IFRS Interpretations Committee paper titled "Variable Payments for the Separate Acquisition of Property, Plant and Equipment and Intangible Assets." Two alternatives were put forward in that paper. One alternative was consistent with View A above. The other alternative held that contingent consideration payments that are dependent on actions of the buyer do not meet the definition of a financial liability until those actions are performed. For example, in the fact pattern at hand, if Entity A chooses not to meet the production milestones, the contingent consideration will not be paid. Therefore, Entity A controls, and can avoid, the obligation to pay consideration.

This view is consistent with the principles of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* In accordance with IAS 37, only those obligations arising from past events that exist independently of the entity's future actions are recognized as provisions. The amount recognized as a provision is the best estimate of the expenditure required to settle the obligation.

View C – IFRS guidance is unclear and therefore there is an accounting policy choice.

There is little IFRS guidance in this area. The IFRS Interpretations Committee was unable to reach a consensus on this topic. In July 2013, the IASB observed that variable payments were being considered in both the Leases and Conceptual Framework projects, and concluded that the issue should be reconsidered after the redeliberation of the proposals in its May 2013 Exposure Draft, "Leases."

Subsequent accounting for changes in contingent consideration

A second issue was addressed to determine what the subsequent accounting should be for changes in contingent consideration. Various alternatives were presented in the fact pattern depending on the views in the initial question.

The Group's Discussion

Group members expressed diverse views on this issue.

Some Group members noted that View A could be supported by guidance in IAS 39 *Financial Instruments* regarding financial liabilities that contain variability in payments. Other Group members observed that it is difficult to ignore the contingent consideration in an asset acquisition if the facts and circumstances closely resemble a business combination. In this case, guidance in IFRS 3 is referred to by analogy. Some members questioned whether it would be practical for a buyer to avoid the production milestones (i.e., if there would be significant penalties) and commented that the seller would have factored in the probability of paying the contingent consideration when determining the purchase price.

Some Group members noted that when IFRS 3 was developed, it was designed to address the accounting for a contingent liability assumed in a business combination at the acquisition date. This could support View B. Contrary to IAS 37, IFRS 3 supports the recognition of a contingent liability even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation. However, this fact pattern is outside the scope of IFRS 3 because the assets acquired do not constitute a business. Therefore, the recognition and measurement of the contingent consideration should be in accordance with IAS 37.

Other Group members observed that View C could be supported as well because the IFRS Interpretations Committee's discussion on this topic has led stakeholders to think there is a policy choice relating to how to account for variable payments. Economic compulsion is also an important factor in determining whether the consideration should be accounted for as a financial liability or a contingency.

Many members thought the accounting should be dependent on the specific fact pattern and that neither view could be discounted outright.

The Group recommended that the AcSB monitor the IASB's consideration of this issue as part of its Leases and Conceptual Framework projects to assess whether further action is needed.